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Do Households Appreciate Their Financial Vulnerabilities? An Analysis of Actions, Perceptions, and Public Policy*

The ACCF Center for Policy Research is pleased to announce that Stanford University Professor B. Douglas Bernheim has received the 1994 ACCF Center for Policy Research "Fellowship for the Study of Personal Saving." Dr. Bernheim's research is being made possible by a major grant from The TCW Group, Inc., a leading investment management company. Additional financial support was provided by the Investment Company Institute; Merrill Lynch; Pierce Fenner & Smith, Inc.; Securities Industry Association; Dean Witter; Discover & Company; National Association of Securities Dealers, Inc.; Prudential Securities, Inc.; and the J.L. Kirkpatrick Foundation for Pension Actuarial Education and Research. Professor Bernheim is also a member of the board of directors of the ACCF Center for Policy Research.

Introduction

Low rates of saving in the United States have perplexed economists and challenged policymakers for more than a decade. Despite widespread agreement that Americans save too little, both from an individual and a social perspective, there is little consensus concerning the appropriate policy response, according to Professor B. Douglas Bernheim's new study, "Do Households Appreciate Their Financial Vulnerabilities? An Analysis of Actions, Perceptions, and Public Policy." For the most part, policy discussions have focused on tax incentives, with analysts disagreeing sharply about the efficacy of this approach.

The purpose of Professor Bernheim's study is to provide evidence on the probable effects of different information policies by answering three questions. First, do households understand their financial vulnerabilities? The answer to this question establishes the potential scope for policies designed to raise awareness about the need for saving. Second, how are households likely to respond to the widespread dissemination of Social Security benefit statements? Third, would the provision of limited computational aids significantly alter behavior?

Personal Saving—How Much Is Adequate?

To evaluate the adequacy of retirement preparation by members of any given generation, one must first establish a quantitative standard of adequacy, Dr. Bernheim notes. There are many possible choices. For example, one can evaluate adequacy relative to some notion of "absolute" need (e.g., the poverty level), adequacy relative to prevailing standards of living among the nonelderly, adequacy relative to the standard of living enjoyed by the elderly of a previous generation, adequacy relative to the standard of living enjoyed by the elderly in other countries, or adequacy relative to an individual's own lifetime standards. There is no "right" or "wrong" standard of adequacy; rather, the use of different standards corresponds to different questions about retirement prospects. The appropriateness of a given standard must be judged within the context of a particular issue. A standard that is appropriate in one context may be inappropriate in another. According to Professor Bernheim, the most useful concept of adequacy evaluates a retiree's living standard relative to his or her own preretirement living standard. Using this measure, inadequate saving implies that a household will be forced to accept a lower standard of living during

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retirement; if the savings shortfall is severe, the decline in living standard will be precipitous. This measure is appropriate in a variety of contexts. Suppose, for example, that the object is to provide households with financial guidance. Since most households wish to avoid sharp declines in their living standard, prescriptions based on equalization of preretirement and postretirement living standards are appropriate. In contrast, it would be entirely inappropriate to base financial recommendations on an absolute measure of adequacy, such as avoiding poverty. The majority of households, upon finding themselves living just above the poverty level after retirement, would conclude that they had saved inadequately. Similarly, those who had achieved lifetime earnings substantially in excess of their parents' might be severely disappointed if their standard of living in retirement did not also exceed their parents'.

"Baby boomers, on average, are not saving enough to achieve even their parents' standard of living during retirement, let along the standard they themselves are enjoying prior to retirement."

Some recent studies, including a 1993 report by the Congressional Budget Office (CBO), attempt to make the case that baby boomers will fare well in comparison to retirees of previous generations. According to the CBO study, baby boomers have significantly higher real incomes and greater accumulated wealth than their parents did at comparable ages. While these findings appear to suggest that baby boomers are on track to match or exceed their parents' standard of living during retirement, caution is warranted for several reasons, Professor Bernheim observes.

First, the CBO's discussion of wealth accumulation focuses on the level of saving, rather than on the rate of saving. In other words, it indicates where households are, without attempting to determine where, or how fast, they are going. This is important, because rates of saving among young workers may have been higher during the late 1950s and early 1960s than in the late 1980s and early 1990s.

Second, the baby boomers' parents earned significantly more during their 50s and early 60s than during their 30s and 40s, in large part because real wages grew rapidly during the 1960s and in the first half of the 1970s. Unless we observe a return to higher sustained real wage growth (which seems unlikely given current rates of saving and investment), baby boomers will benefit from much lower midcareer growth in earnings.

Third, baby boomers may receive less generous pension benefits than their parents. With respect to potential reductions in Social Security, a 1993 study by Professors Alan Auerbach of the University of Pennsylvania and Lawrence Kotlikoff of Boston University found that, under a sustainable fiscal policy, most baby boomers would have a lower standard of living in retirement than their parents. And even if the benefit formulas are unaltered, Social Security will probably replace a smaller fraction of preretirement income for the baby boomers. This follows from the growth of two-earner households, since single-earner married couples receive a pure windfall in the form of the spousal benefit.

In addition, many private companies have taken steps to reduce retirement benefits, partly in response to the increasing complexity of federal regulation. In many instances, these steps have been subtle and indirect. For example, in recent years there has been a dramatic shift from traditional pension plans to 401(k) plans. Baby boomers' pension assets are also invested much more conservatively than their parents' pension assets (due again to the growth of defined contribution pension plans and 401(k)s, which give workers more control over their portfolios). This means that they can expect to receive, over the long haul, much lower returns. Even if they are doing as well at age thirty-five, they are likely to fall far behind by age sixty-five.

Fourth, the baby boomers' parents benefited from an enormous, unexpected increase in housing equity. They experienced both a prolonged period of high inflation that wiped out much of their real liabilities (by reducing the real value of fixed rate mortgages), and a sharp increase in the relative price of housing (most likely driven by baby boom population dynamics). In contrast, baby boomers are unlikely to earn large windfalls on their homes. Indeed, it is generally believed that demographic trends will drive real housing prices down as the baby boomers approach retirement. Similarly, large net outflows from pension funds may depress asset prices, thereby significantly reducing the net worth of baby boomers subsequent to their retirement. It is also doubtful that inflation will significantly erode the value of the baby boomers' liabilities. Even if we experience a

return to high inflation, many baby boomers have opted for adjustable rate mortgages.

Fifth, the baby boomers are having their children later than their parents did. This means that they will have fewer post-child rearing years to accumulate resources for retirement at an accelerated rate. Baby boomers also have fewer children than their parents. This implies that children are currently less of a drain on their income, and that, consequently, the end of child rearing will have less of an effect on their ability to save.

Sixth, baby boomers will live significantly longer than their parents, so their savings need to go further. There is growing evidence that official mortality projections may significantly understate the longevity of those retiring in the next century. New research suggests that if current rates of progress in reducing mortality at advanced ages continue or accelerate, children alive today may live to see ninety or even 100 years on average, Professor Bernheim notes.

Seventh, baby boomers will exhaust a larger fraction of their wealth sending their children to college, both because their children are more likely to attend college, and because the real costs of college have risen. This consideration may be offset to some extent by the fact baby boomers are having fewer children than their parents did.

Certainly, there are some factors that tend to favor the baby boomers, relative to their parents, not the least of which is their larger real incomes at comparable ages. A minority of baby boomers may also receive significant inheritances. However, given the range and quantitative importance of the factors discussed above, it seems evident that baby boomers, on average, are not saving enough to achieve even their parents' standard of living during retirement, let alone the standard they themselves are enjoying, and will continue to enjoy, prior to retirement.

Financial Vulnerabilities

Professor Bernheim uses data from a nationally representative telephone survey, conducted in the fall of 1993 by Luntz Weber Research and Strategic Services for Merrill Lynch, Inc. The survey was administered to 1,209 randomly selected individuals between the ages of twenty-nine and forty-seven (the "baby boom" cohort). The survey contains both a question on target saving, and a question on actual saving. These questions read as follows:

- What percentage of your annual household income do you think you should save for retirement? ("target saving")

	Actual rate of saving	Target rate of saving
Median	5.0%	15.0%
Mean	8.1%	19.2%
Mode	0%	10.0%

- What percentage of your annual household income are you now saving for retirement? ("actual saving")

The response rates for both questions exceeded 98 percent. A comparison of the answers to these questions provides a measure of the self-assessed adequacy of saving, Professor Bernheim advises.

Summary statistics on actual rates of saving (self-assessed) are contained in Table 1. The median self-reported rate of saving for retirement is only 5 percent. Since the distribution of saving rates is skewed (with a small number of individuals reporting very high rates), the mean rate of saving is somewhat higher (8.1 percent). It is particularly notable that the modal self-reported rate of saving is 0 percent: fully 20.9 percent of respondents reported that they save nothing for retirement. This distribution is highly concentrated between 0 percent and 10 percent. Furthermore, 37.1 percent of respondents report saving less than 5 percent of income, and only 19.9 percent report saving more than 10 percent of income.

Table 1 also contains summary statistics on target rates of saving (self-reported). The median self-reported target rate of saving is 15 percent. Once again, the mean rate is noticeably higher (19.2 percent), reflecting the skewness of the distribution. The modal rate of target saving is 10 percent; slightly more than 30 percent of respondents believe that they should put away 10 percent of income toward retirement. Fewer than 1 percent of respondents said they did not need to save anything for retirement; only 2.3 percent reported a target saving rate less than 5 percent; only 11.6 percent believed they should be saving less than 10 percent of income; and a sizable minority of respondents—28.0 percent—named a target saving rate of 20 percent or more.

The contrast between actual saving and target saving is striking. The data clearly indicate that baby boomers recognize the need to save more, and that, in the aggregate, they appreciate the extent to which they ought to increase their saving. The median baby boomer believes that it would be appropriate to triple his or her

rate of saving for retirement—a conclusion that coincides almost exactly with that of Professor Bernheim's earlier research.

Dr. Bernheim's findings show that current saving by members of the baby boom generation is seriously inadequate. The typical baby boom household is saving at one-third the rate required to finance a standard of living during retirement comparable to the standard of living enjoyed before retirement.

Using the Luntz Webber/Merrill Lynch survey data, Dr. Bernheim finds that while respondents indicate some awareness of relative financial vulnerabilities, they also exhibit an unrealistic degree of optimism. Within the lowest adjusted-wealth quartile—a group that is poorly prepared by any objective measure of adequacy—more than half regard their personal finances as secure. Many members of this population acknowledge that they save significantly less than they should, while simultaneously maintaining an unrealistic level of optimism concerning personal finances and retirement prospects. For at least this fraction of the population, and possibly for others as well, the failure to save adequately may well result from self-deception.

Table 2 Asset Accumulation and Confidence in Social Security

Individual's expectation about future social security benefits	Wealth/earnings ratio		
	Age 30	Age 47	Change
No future benefits	0.320	1.365	1.045
Lower future benefits	0.283	0.846	0.563
Same future benefits	0.367	0.455	0.088

The Impact of Information Policies

As of 1995, the federal government will provide a "Personal Earnings and Benefit Estimate Statement" to older workers. In subsequent years, the Social Security Administration will send these statements automatically to younger workers as well.

However, the Luntz Webber/Merrill Lynch survey results suggest the federal government's plan to distribute Social Security benefit statements could discourage personal saving. First, most recipients of these statements would be pleasantly surprised by the apparent generosity of the system. Second, the benefit statements may enhance people's confidence that benefits will not be reduced or eliminated. Professor Bernheim concludes that the benefit statement policy might depress personal saving because virtually all saving among the baby boom generation is undertaken by those who have little or no confidence in the Social Security system (see Table 2). As of age thirty, there are only minor differences between the wealth-to-earnings ratios for those who expect no Social Security benefits, those who expect lower benefits than current retirees, and those who expect the same benefits as provided under current law. However, by age forty-seven (the maximum age of respondents in the data sample) the differences are enormous. The estimates indicate that, over the intervening seventeen years, those with the least confidence in Social Security (i.e., those who say they expect to receive no benefits) accumulate incremental wealth equal to slightly more than one year's worth of earnings.

Conclusion and Policy Recommendations

The survey results also show that individual's saving behavior responds to vague and unquantified senses of security and urgency, rather than to quantitative (measured) perceptions of financial needs. Since the government policies currently under serious consideration may well prove ineffective for raising personal saving (in fact, the distribution of Social Security benefit statements may reduce personal saving), more ambitious information policies—including promotion and the provision or facilitation of explicit advice and guidance—deserve serious consideration, Professor Bernheim concludes. ❖